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DEPARTMENT OF THE TREASURY

Internal Revenue Service

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Source of Income from Certain Space and Ocean Activities; Source of Communications Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 863(d) governing the source of income from certain space and ocean activities. It also contains final regulations under section 863(a), (d), and (e) governing the source of income from certain communications activities. In addition, this document contains final regulations under section 863(a) and (b), amending the regulations in §1.863-3 to conform those regulations to these final regulations. The final regulations primarily affect persons who derive income from activities conducted in space, or on or under water not within the jurisdiction of a foreign country, possession of the United States, or the United States (in international water). The final regulations also affect persons who derive income from transmission of communications.

DATES: Effective Date: These regulations are effective December 27, 2006.

Applicability Date: For dates of applicability, see §1.863-8(h) and §1.863-9(l).

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toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1718.

The collections of information in these final regulations are in §§1.863-8(g) and 1.863-9(k). This information is required by the IRS to monitor compliance with the Federal tax rules for determining the source of income from space or ocean activities, or from transmission of communications.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent is 5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law.

Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Congress enacted section 863(d) and (e) as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. Section 863(d) governs the source of income derived from space or ocean activities. Section 863(e) governs the source of income derived from international communications activities.

The Treasury Department and the IRS published a notice of proposed rulemaking (REG-106030-98) in the **Federal Register** on January 17, 2001 (66 FR 3903), which provided proposed regulations under section 863(a), (b), (d), and (e) (the 2001 proposed regulations). The Treasury Department and the IRS received numerous written comments on the 2001 proposed regulations and held a public hearing on May 23, 2001. Since that time, the aerospace, telecommunications, and related industries have experienced substantial technological evolution and significant business change and consolidation. In addition, the American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, 118 Stat. 1418, enacted a number of materially relevant statutory changes that affect the treatment of space and ocean income for purposes of the foreign tax credit and subpart F rules.

In light of the extensive written comments, industry evolution, and AJCA changes, the Treasury Department and the IRS felt that it was appropriate to repropose these regulations to reflect these changes and to provide another opportunity for comment. Consequently, the Treasury Department and the IRS published another

notice of proposed rulemaking in the **Federal Register** on September 19, 2005 (70 FR 54859), which withdrew the 2001 proposed regulations and provided new proposed regulations under section 863(a), (b), (d), and (e) (the proposed regulations). The proposed regulations provided two sets of rules: one in §1.863-8 for determining the source of income from space or ocean activities, the other in §1.863-9 for determining the source of income from communications activities.

A public hearing on the proposed regulations was scheduled for December 15, 2005, but was ultimately cancelled because no one requested to speak. A few written comments, however, were received. These comments uniformly praised the proposed regulations as an improvement over the 2001 proposed regulations and generally were supportive of much of the proposed regulations. However, commentators suggested a few additional changes. After consideration of these comments, the proposed regulations are adopted as final regulations, as amended by this Treasury decision. The revisions to regulations governing the source of income from space or ocean activities and the source of income from communications activities are discussed in section A and section B, respectively, of this preamble.

Summary of Comments and Explanation of Revisions

A. Space or Ocean Activity under Section 863(d)

Section 863(d) governs the source of income from certain space or ocean activities. In general, section 863(d)(1) provides that, except as provided in regulations, any income derived from a space or ocean activity (space and ocean income) is income from sources within the United States (U.S. source income) if derived by a United

States person and is income from sources without the United States (foreign source income) if derived by a foreign person. Section 863(d)(2)(A)(i) defines space activity to include any activity conducted in space. Section 863(d)(2)(A)(ii) defines ocean activity to include any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States. Section 863(d)(2)(B) excludes three types of activities from the definition of space or ocean activity. Space or ocean activity does not include any activity giving rise to transportation income governed by section 863(c), international communications income governed by section 863(e), or income with respect to mines, oil and gas wells, or other natural deposits to the extent within the United States or any foreign country or possession of the United States (as defined in section 638). See Section 863(d)(2)(B).

Section 1.863-8 of the proposed regulations generally provided rules for determining the source of income derived from space or ocean activity under section 863(d). Section 1.863-8(b)(1) of the proposed regulations reflected the general source rule under section 863(d)(1) that a United States person's space and ocean income is U.S. source income. Pursuant to the grant of regulatory authority under section 863(d)(1), however, the proposed regulations provided an exception to this general rule. Under that exception, a United States person's space and ocean income is foreign source income (and therefore not sourced on the basis of citizenship or residency) to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or

countries.

For a foreign person, proposed §1.863-8(b)(2) reflected the general source rule under section 863(d)(1) that a foreign person's space and ocean income is foreign source income. Pursuant to regulatory authority under section 863(d)(1), however, the proposed regulations contained two exceptions to this general rule, one for controlled foreign corporations (CFCs), the other for foreign persons engaged in a U.S. trade or business. The proposed regulations generally sourced space and ocean income derived by a CFC, like that of a United States person, as U.S. source income. However, also like the rule for a United States person, a CFC's space and ocean income is foreign source income to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries. For a foreign person, other than a CFC, engaged in a trade or business within the United States, space and ocean income is U.S. source income to the extent it is attributable to functions performed, resources employed, or risks assumed within the United States.

In addition to the general source rules for United States and foreign persons, the proposed regulations provided special rules, applicable to both United States and foreign persons, for income from services, certain sales of property, and communications activities (other than international communications activities). These special rules, as well as modifications to the proposed regulations, are discussed below.

1. Activities performed outside space and international water

Section 1.863-8 of the proposed regulations provided source rules only for

income from space or ocean activity. Thus, in some cases, income derived from a transaction must be allocated between space and ocean income and other income.

For example, §1.863-8(b)(3)(ii)(C) of the proposed regulations provided that when property is produced both in space or international water and outside space and international water, gross income allocable to production activity is allocated to production occurring in space or international water and production occurring outside space and international water based on where functions are performed, resources are employed, or risks are assumed. The proposed regulations also provided a similar analysis of functions performed, resources employed, or risks assumed to allocate income in the case of performance of services. See Prop. Treas. Reg. §1.863-8(d)(2). Under the proposed regulations, only the amount allocated to production or performance of a service occurring in space or international water is treated as space and ocean income (character rule). The source of gross income allocated to production or performance of a service occurring in space or international water is then determined under the rules of proposed §1.863-8(b)(1) or (2), as applicable (source rule).

Section 1.863-8(b)(1) of the proposed regulations reflected the general source rule that a United States person's space and ocean income is U.S. source income. Proposed §1.863-8(b)(2) reflected the general source rule that a foreign person's space and ocean income is foreign source income. Both proposed §1.863-8(b)(1) and (2), however, provided exceptions to their respective general source rules. As discussed above, under the exceptions, a United States person's space and ocean income may be foreign source income and a foreign person's space and ocean income may be U.S.

source income based on where functions are performed, resources are employed, or risks are assumed.

One commentator noted that in some situations, the allocation of income derived from a transaction to determine space and ocean income based on functions performed, resources employed, or risks assumed presumably would remove the subsequent need to further analyze functions performed, resources employed, or risks assumed within a country to determine the source of the space and ocean income. In other words, the very act of determining the character of income seems to also determine the source of such income.

The Treasury Department and the IRS agree with the commentator that use of the same standard to classify the transaction as space or ocean activity and to source the space and ocean income may be duplicative in some cases. However, there are other cases where a transaction with some land-based activity may be classified in its entirety as a space or ocean activity (for example, a lease of a satellite), but the income may be partially U.S. source and partially foreign source under the source rules of proposed §1.863-8(b)(1) and (2) based on functions performed, resources employed, or risks assumed within the United States or a foreign country. Consequently, the character and source rules are not always duplicative.

Thus, the extent to which the character rules overlap with the source rules is particular to the type of transaction involved. The Treasury Department and the IRS recognize that the overlap in the character and source rules may produce equivalent results. But, the overlap is necessary to provide taxpayers and the IRS with workable

rules. As a result, the final regulations do not follow this comment as a general matter.

Nonetheless, a conforming amendment has been made to the lease transaction in Example 1 in §1.863-8(f) of the final regulations to more clearly illustrate how the rules work. That example illustrates that the transaction involved is first classified in its entirety as a space or ocean activity, and then the resulting space and ocean income is subjected to the source rules. The space and ocean income is sourced as foreign source income to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

2. Activities performed by another person

Section 1.863-8(a) of the proposed regulations provided that a taxpayer will not be considered to derive income from space or ocean activity if such activity is performed by another person. The approach under §1.863-8(a) of the proposed regulations, providing that a taxpayer derives income from a space or ocean activity only if it conducts such activity directly, is consistent with the approach adopted in the §1.863-3 regulations governing the source of income from certain sales of inventory. See, e.g., Treas. Reg. §1.863-3(c) (“[T]he only production activities that are taken into account for purposes of §§1.863-1, 1.863-2, and this section are those conducted directly by the taxpayer.”).

Accordingly, commentators believed that this provision assured that a content provider that retains a satellite operator to transmit programming abroad would not derive space and ocean income based on attribution of the satellite operator’s activity.

The Treasury Department and the IRS agree.

One commentator noted, however, that Examples 2 and 4 in §1.863-8(f) of the proposed regulations seem to indicate that this is not what was intended. In Example 2, the taxpayer, an Internet service provider, transmits information requested by its customer, in part using satellite capacity leased from a third party. Example 2 concludes that the service performed by the taxpayer is considered space activity to the extent the value of the service is attributable to functions performed, resources employed, and risks assumed in space. In Example 4, the taxpayer uses satellite capacity acquired from a third party to deliver programming services directly to its customers' televisions sets. Example 4 concludes that the taxpayer's delivery of programming and other services is considered space activity to the extent the value of the delivery transaction is attributable to performance in space. In the commentator's view, the results reached in the examples conflict with the provision stating that activities performed by another person are not attributable to the taxpayer.

The Treasury Department and the IRS do not believe that Examples 2 and 4 of §1.863-8(f) of the proposed regulations produce the result that the commentator raised. In Examples 2 and 4, the taxpayer performed the transmission or delivery activities using satellite capacity leased or acquired from a third party. Both Examples 2 and 4 correctly conclude that the taxpayers derived space and ocean income from their own activities rather than from activities of another person. Thus, the examples do not, in fact, conflict with the text of the proposed regulations. Nevertheless, the Treasury Department and the IRS are concerned that Examples 2 and 4 have been

misinterpreted as suggesting that activities performed by another person may be attributable to the taxpayer in certain situations. This was not the intent of these examples. Consequently, Examples 2 and 4 in §1.863-8(f) of the final regulations have been modified to make clear that the taxpayers in the examples directly engage in a space activity by performing the uplink (transmitting to the satellite) and downlink functions.

These examples differ from cases in which the taxpayer is a mere content provider that derives income either from the creation of content or from the creation and delivery of content, but in either case contracts with another person to deliver the content via satellite. Pursuant to §1.863-8(a) of the final regulations, content providers of this type would not derive space and ocean income because the delivery of the content via satellite is performed by another person. This would be the result even though the value of the customer contract includes a payment to the content provider for space or ocean activity. To clarify the distinction between these situations and Examples 2 and 4, a new Example 5 has been added to the final regulations. That example involves a content provider that does not derive space and ocean income because the taxpayer does not directly perform any space or ocean activity.

3. Income characterization rules for income from services and the de minimis exception

Under §1.863-8(b)(4) of the proposed regulations, to the extent a service is characterized as space or ocean activity, the source of gross income derived from such transaction is determined under proposed §1.863-8(b)(1) or (2), as applicable. Section 1.863-8(d)(2)(ii)(B) of the proposed regulations provided, however, that if the taxpayer

can demonstrate, based on all the facts and circumstances, that the value of the service attributable to performance in space or international water is de minimis, such service will not be treated as space or ocean activity. The de minimis rule was adopted to address taxpayers' concerns about potential confusion in qualifying for the "facilitation exception" under the 2001 proposed regulations. One commentator stated that the de minimis rule simply replaced one vague standard with another, as neither Example 3 in §1.863-8(f) of the proposed regulations nor the text of the proposed regulations provides any guidance as to when activities performed in space or international water would be de minimis under a facts and circumstances approach.

The Treasury Department and the IRS recognize that issues of interpretation may arise in any facts and circumstances approach. Nevertheless, the Treasury Department and the IRS generally have refrained from adopting the alternative approach, to wit, adopting precise definitions and quantitative measures for a de minimis standard. Moreover, the inclusion of a precise definition and quantitative measures for determining de minimis value could raise equal, if not greater, concerns in terms of the quantitative threshold and other issues. Thus, the final regulations retain the de minimis standard for determining whether a taxpayer has space and ocean income. If the value of the service attributable to space or ocean activity is de minimis based on the facts and circumstances, the taxpayer will not derive space and ocean income. Nevertheless, the Treasury Department and the IRS agree that more guidance could be provided as to the application of the retained de minimis rule. Accordingly, Examples 3 and 8 in §1.863-8(f) of the final regulations (Example 7 in the proposed

regulations) provide clearer illustrations of when activities performed in space or international water would be considered de minimis for this purpose and when those types of activities would not be considered de minimis.

4. Source rules for income from certain sales of property

The proposed regulations provided special rules for income from certain sales of property, either when any production occurs in space or international water, or when the sale occurs in space or international water. In either case, section 863(d) and the proposed regulations applied to determine the source of income from the sales of property, and the rules of sections 861(a)(6), 862(a)(6), 863(a), 863(b), and 865 apply only to the extent provided in the proposed regulations.

a. Sales of Property Produced in the United States and Sold in Space or International Water

Section 1.863-8(b)(3)(ii) of the proposed regulations provided that when the taxpayer both produces property and sells such property, one-half of the taxpayer's gross income will be considered income allocable to production activity and one-half of such gross income will be considered income allocable to sales activity. Taxpayers generally must then apply the rules of section 863(d) and the proposed regulations to determine the source of income allocable to production activity and sales activity.

For production activity, the source of gross income allocable to production occurring in space or international water is generally based on the citizenship or residence of the taxpayer, applying the rules of proposed §1.863-8(b)(1) or (2), as applicable. The source of gross income allocable to production occurring outside space and international water is determined under section 863(b) rather than section 863(d).

See Prop. Treas. Reg. §1.863-8(b)(3)(ii)(B) (referencing Treas. Reg. §1.863-3(c)(1)).

As for sales activity, when property is sold in space or international water, the source of gross income allocable to sales activity is generally based on the citizenship or residence of the taxpayer, applying the rules of proposed §1.863-8(b)(1) or (2), as applicable. An exception to this general rule applied in cases when the property sold is inventory, within the meaning of section 1221(a)(1), and is sold in space or international water for use, consumption, or disposition outside space, international water, and the United States. In that case, the source of gross income allocable to sales activity is determined under Treas. Reg. §1.861-7(c) and §1.863-3(c)(2). Treas. Reg. §1.861-7(c) and §1.863-3(c)(2) generally provide for foreign source income where the seller's rights, title, and interest in the property are transferred to the buyer (the title passage rule) outside the United States and the property is not sold for use, consumption, or disposition in the United States. Treas. Reg. §1.861-7(c) and §1.863-3(c)(2) also applied to property sold outside space and international water. See Prop. Treas. Reg. §1.863-8(b)(3)(ii)(D).

One commentator believed that because certain U.S. manufacturers, such as U.S. satellite manufacturers, produce property that is sold in space or international water for use, consumption, or disposition in space or international water, they are at a disadvantage relative to U.S. manufacturers of other export property because the former may have U.S. source income with respect to income allocable to sales activity, while the latter may have foreign source income from sales activity.

In response to comments on the 2001 proposed regulations, proposed §1.863-

8(b)(1) was revised to provide that space and ocean income will be foreign source income to the extent the space and ocean income is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries. The Treasury Department and the IRS believe that this change may in many cases mitigate concerns about U.S. manufacturers potentially deriving 100 percent U.S. source income in these cases. Moreover, the Treasury Department and the IRS believe that the rules under the proposed regulations for determining the source of income allocable to sales activity are consistent with legislative intent to assert primary tax jurisdiction over income earned by United States persons that is not subject to foreign tax. See S. REP. NO. 99–313, 1986-3 C.B. 357-358 (“[T]he committee believes the United States should assert primary tax jurisdiction over income earned by its residents that is not within any foreign country’s taxing jurisdiction....Moreover, when a U.S. taxpayer conducts activities in space or international waters, foreign countries generally do not tax the income. Thus, the foreign tax credit limitation is inflated by income that is not within any foreign country’s tax jurisdiction.”). Based on the legislative history, the Treasury Department and the IRS believe that sales of property in space or international water -- with the exception of sales of inventory property in space or international water for use, consumption, or disposition outside space, international water, and the United States -- should be considered space or ocean activity and that the source of income from such sales activity should be determined under section 863(d). As a result, no changes were made in response to this comment.

b. Purchased Versus Produced Property Sold for Use, Consumption, or Disposition in the United States

One commentator questioned the appropriateness of differences in determining the source of sales income depending on whether the taxpayer produced or purchased the property sold. Under the proposed regulations, when property produced by the taxpayer is sold in space or international water, the source of gross income allocable to sales activity is generally based on the citizenship or residence of the taxpayer, applying the rules of proposed §1.863-8(b)(1) or (2), as applicable (and not the title passage rule) -- subject to the foregoing inventory exception for property that will be used, consumed, or disposed of outside space, international water, and the United States. A slightly different rule applied to sales of property that had been purchased by the taxpayer. While the proposed regulations also provided that, for purchased property, the source of gross income allocable to sales activity is generally based on the citizenship or residence of the taxpayer, the inventory exception for purchased property only required that the property be used, consumed, or disposed of outside space and international water.

The inventory exceptions for produced and purchased property were intended to produce different results when inventory property is used, consumed, or disposed of in the United States. In such case, the source of produced inventory property sales income is generally based on the citizenship or residence of the taxpayer, applying the rules of proposed §1.863-8(b)(1) or (2), because the inventory exception did not extend to produced property sold for use, consumption, or disposition in the United States. In contrast, the source of purchased inventory property sales income is generally based on title passage under Treas. Reg. §1.861-7(c) because the inventory exception did extend

to purchased property even if it was sold for use, consumption, or disposition in the United States. The Treasury Department and the IRS believe that this difference between the produced and purchased property rules in the space and ocean context is consistent with the difference in the rules for sales of produced and purchased property outside the space and ocean context. In particular, under section 863(a) and (b) and the regulations thereunder, if property is produced in the United States and sold for use, consumption, or disposition in the United States, the place of sale will be presumed to be the United States, and income attributable to the sales activity will be U.S. source income. See §1.863-3(c)(2). There is, however, no comparable rule for purchased property under section 862(a)(6) or the regulations thereunder. Thus, the final regulations simply continue in the space and ocean context the varying treatment elsewhere for sales of purchased property and sales of produced property.

In response to comments, however, the produced and purchased property rules have been modified to be similar in structure and style, to better reflect and highlight the differences between these two rules.

5. Allocations

Taxpayers must allocate gross income under paragraphs (b)(1) and (b)(2) of proposed §1.863-8 among U.S., foreign, and space or ocean activities. Under proposed §1.863-8(b)(3)(ii)(C), allocations are also made between production activity occurring in space or international water and that occurring outside space and international water. Finally, allocations are also made under proposed §1.863-8(b)(4) between services performed in space or international water and services performed

outside space and international water. In performing these allocations, the proposed regulations generally provided that taxpayers should consider the relative value of functions performed, resources employed, or risks assumed in different locations. Moreover, the preamble to the proposed regulations provided that allocations should be based generally on section 482 principles. Commentators noted that little guidance is given as to the mechanics of allocation other than the statement that the principles of section 482 should be used. Commentators stated that allocation of gross income based on section 482 principles will result in added expense, uncertainty, and extra burden on multinational taxpayers who are already required to undertake and update functional analyses and satisfy substantial documentation requirements.

While the final regulations were not changed in response to these comments, the Treasury Department and the IRS believe that some clarification is warranted. In suggesting the use of section 482 principles as a guide, the Treasury Department and the IRS intend for taxpayers to adopt a reasonable approach to the allocations required in this area. Taxpayers know their businesses and will generally be in the best position to fashion a reasonable method that most reliably reflects the relative value of functions performed, resources employed, and risks assumed in different locations. In the preamble to the proposed regulations, the Treasury Department and the IRS solicited comments on alternative methods of allocation for particular industries and criteria that could be used to evaluate the reasonableness of such methods. No such comments were received. One commentator noted, however, that the proposed regulations perhaps reflected what taxpayers in these industries have already been doing in order

to determine the character and source of their space and ocean income. Consequently, the Treasury Department and the IRS believe that allocations of gross income based on functions performed, resources employed, and risks assumed are appropriate in these circumstances.

6. Separation of a single transaction and aggregation of multiple transactions

Paragraphs (d)(1)(i) and (d)(1)(ii) of §1.863-8 of the proposed regulations provided that for purposes of determining space or ocean activity, the Commissioner may separate parts of a single transaction or combine separate transactions into a single transaction. One commentator stated that this is a “one-way” street, as only the Commissioner has the authority to separate or combine transactions for purposes of the proposed regulations.

The final regulations do not change this rule. The Treasury Department and the IRS believe taxpayers are not inappropriately disadvantaged by this rule because taxpayers generally have the ability to structure their transactions in line with the economic prospects of their businesses. In addition, the Commissioner’s ability to separate or combine transactions is not unfettered. Rather, the Commissioner may only separate or combine transactions to better reflect the value of functions performed, resources employed, or risks assumed. A taxpayer can always protect itself against recharacterization by adopting an arrangement that appropriately reflects the economic realities of a transaction or series of transactions. The taxpayer is clearly in the best position at the outset to structure its arrangements in this manner. In addition, taxpayers traditionally are not permitted to restructure retroactively the form of their

completed transactions. Thus, the Treasury Department and the IRS believe that the limited “one-way” rule is appropriate in this case.

7. Income derived from the leasing of shipping cargo containers

One commentator requested that the Treasury Department and the IRS make clear that the final regulations under section 863(d) do not apply to income derived from the leasing of shipping cargo containers and that such income should be treated as rental income, sourced under sections 861 and 862. This commentator noted that valid arguments also exist for treating income derived from the leasing of shipping cargo containers as transportation income; however, in the commentator’s view, the most appropriate treatment is rental income treatment, sourced under sections 861 and 862.

The treatment of income derived from the leasing of shipping cargo containers is not covered by these final regulations. Instead, the Treasury Department and the IRS intend to address the treatment of such income explicitly in separate guidance. That guidance may apply section 863(c), section 863(d), or other provisions to source income derived from the leasing of shipping cargo containers. Any such guidance will be prospective in nature. Until such time, the treatment of such income will be determined under existing law.

B. Communications Activity under Section 863(a), (d), and (e)

Section 863(e) governs the source of income from international communications activities (international communications income). International communications income is defined in section 863(e)(2) as income derived from the transmission of communications or data between the United States and a foreign country (or

possession of the United States). Section 863(e)(1)(A) provides that any international communications income of a United States person is sourced 50 percent in the United States and 50 percent outside the United States (50/50 source rule). Section 863(e)(1)(A) does not provide for any statutory or regulatory exceptions to this 50/50 source rule. In contrast, section 863(e)(1)(B)(i) provides that any international communications income of a foreign person is sourced outside the United States, except as provided in regulations or in section 863(e)(1)(B)(ii). The exception under section 863(e)(1)(B)(ii) provides that if a foreign person maintains an office or other fixed place of business in the United States, any international communications income attributable to such office or other fixed place of business is U.S. source income.

Section 1.863-9 of the proposed regulations generally provided rules for determining the source of international communications income under section 863(e) and other communications income under section 863(a) and (d). Proposed §1.863-9(b)(1) reflected the rule under section 863(e)(1)(A) that a United States person's international communications income is 50 percent U.S. source income and 50 percent foreign source income. Proposed §1.863-9(b)(2) reflected the general rule under section 863(e)(1)(B) that a foreign person's international communications income is foreign source income.

Consistent with the statutory exception under section 863(e)(1)(B)(ii), proposed §1.863-9(b)(2)(iii) provided that any international communications income derived by a foreign person, other than a CFC, that is attributable to an office or other fixed place of business of the foreign person in the United States is U.S. source income. International

communications income is attributable to an office or other fixed place of business to the extent of functions performed, resources employed, or risks assumed by the office or other fixed place of business. In addition to the statutory exception under section 863(e)(1)(B)(ii), section 863(e)(1)(B) provides general regulatory authority to depart from the general 100 percent foreign source rule for foreign persons. Thus, pursuant to this regulatory authority, the proposed regulations contained additional exceptions to the general rule applicable to foreign persons. In particular, the proposed regulations provided that international communications income derived by a CFC is 50 percent U.S. source income and 50 percent foreign source income (the same as for United States persons). The proposed regulations also provided that international communications income derived by a foreign person, other than a CFC, engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

In addition to the general source rules for international communications income of United States and foreign persons, the proposed regulations also provided rules, applicable to both United States and foreign persons, for income from U.S. communications, foreign communications, space/ocean communications, and communications where endpoints are indeterminate. These rules, as well as modifications to the proposed regulations, are discussed below.

1. Income characterization rules for communications income

Section 1.863-9(h)(3) of the proposed regulations provided that the type of

communications activity (and thus the applicable source rule) is determined by identifying the two points between which the taxpayer is paid to transmit the communication. For United States and foreign persons, U.S. communications income is entirely U.S. source income. A taxpayer derives U.S. communications income when the taxpayer is paid to transmit between two points in the United States or between the United States and a point in space or international water. In contrast, foreign communications income is entirely foreign source income for United States and foreign persons. A taxpayer derives foreign communications income when the taxpayer is paid to transmit between two points in a foreign country or countries (or a possession or possessions of the United States), between a foreign country and a possession of the United States, or between a foreign country (or a possession of the United States) and a point in space or international water. Finally, the proposed regulations provided different source rules for international communications income of United States and foreign persons. See section B.3 of this preamble for further discussion. A taxpayer derives international communications income when the taxpayer is paid to transmit between a point in the United States and a point in a foreign country (or a possession of the United States). When a taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication, §1.863-9(f) of the proposed regulation provided a default source rule under which all the income derived by the taxpayer from such communications activity is U.S. source income.

Commentators stated that the treatment of communications income as U.S. source income when the endpoints are indeterminate is overbroad and harsh,

particularly as it relates to foreign taxpayers. Commentators also stated that taxpayers would have to commit significant resources to develop the technology necessary to identify the endpoints of communications. One commentator stated that it is unclear that a reliable system can be created at any expense to establish the endpoints of the transmission under all circumstances. Commentators suggested instead the use of any reasonable method to establish the endpoints between which a taxpayer is paid to transmit the communications. One commentator suggested that the Treasury Department and the IRS consider employing the Industry Issue Resolution Program or Prefiling Agreement Program as aids in the administration of a reasonable method rule.

The Treasury Department and the IRS solicited comments on the challenges to identifying the endpoints of communications in specific industries or situations, as well as suggestions for rules that are responsive to these particular challenges. The Treasury Department and the IRS also solicited comments on methods to establish the endpoints of a communication that may be reasonable for particular industries, as well as criteria that may be appropriate to evaluate the reasonableness of such methods. In response, one commentator submitted examples of reasonable methods to establish the endpoints between which a taxpayer is paid to transmit the communications. The examples relied on statistical reports of data such as minutes used, areas of transmission, port locations, and transport charges. This commentator noted that current federal regulations already require telecommunications companies to submit some of these reports to certain governmental agencies, for example, the Federal Communications Commission.

In light of the potential complexity in identifying the type of communications activity and in response to comments, the final regulations provide that a taxpayer may satisfy the requirement that the taxpayer establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication by using any consistently applied reasonable method to establish one or both endpoints. In doing so, the taxpayer carries the burden of proof and must establish that the method used is reasonable (taking into account all of the facts and circumstances) and is consistently applied. In satisfying its burden of proof, a taxpayer will need to maintain reasonable records of communications activities. Depending on the facts and circumstances, methods based on, for example, records of port or transport charges, customer billing records, a satellite footprint, or records of termination fees made pursuant to an international settlement agreement may be reasonable. In addition, practices used by taxpayers to classify or categorize certain communications activity in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint ventures, or other parties or governmental agencies in interest may be reliable indicators of the reasonableness of the method chosen, but need not be accorded conclusive weight by the Commissioner. Furthermore, in evaluating the reasonableness of the method chosen, consideration will be given to all the facts and circumstances, including whether the endpoints would otherwise be identifiable absent this reasonable method provision.

Along with resultant changes made to the text of the final regulations, several examples have been added to §1.863-9(j) of the final regulations that illustrate

instances where the taxpayer may be able to use reasonable methods to determine the endpoints between which the taxpayer is paid to transmit the communications.

2. The paid-to-do rule with respect to foreign-originating communications

Under the proposed regulations, a taxpayer derives income from a certain type of communications activity (for example, foreign communications or international communications) only if the taxpayer is paid to transmit, and bears the risk of transmitting (the paid-to-do rule), the communications of such type. See Prop. Treas. Reg. §1.863-9(h)(2) and (3). This is the case even if the taxpayer contracts out the transmission function.

Commentators stated that application of the paid-to-do rule in all instances would give rise to results that are inconsistent with Congressional intent and may result in excessive amounts of U.S. source income. One commentator noted that in some cases, while it is clear that a communication originated in a foreign country and that a U.S. telecommunications company is paid to terminate the foreign-originating traffic in the United States, it is unclear exactly where the U.S. telecommunications company picked up the communication. This lack of clarity often may be due to legal restrictions in certain foreign countries on ownership of capacity and carriage of transmissions by non-nationals. It can also be due to the fact that the international settlement agreements under which major international telecommunications carriers operate often do not specify where the traffic is picked up or handed off, and in some cases the hand-off point is specified by reference to a mid-point convention, even though the transmission signal, from a technical standpoint, travels from end-to-end with no real

points in-between. The commentator further stated that at the time section 863(e) was enacted, U.S. carriers were generally not allowed to own and operate facilities in foreign countries; specifically, no U.S. carrier could carry a foreign-to-U.S. or U.S.-to-foreign transmission end-to-end. Thus, concluded the commentator, Congress focused on the endpoints of the communications rather than where the activities constituting the transmission of communications take place. The commentator suggested a rule that would provide that when a taxpayer is paid to transmit foreign-originating communications from a point outside the United States to a point in the United States, the taxpayer should be deemed to have been paid to transmit the communications from a point in the foreign country in which the communication originated.

Upon further consideration, the Treasury Department and the IRS believe that the paid-to-do rule may be over-inclusive in certain cases. Accordingly, the final regulations provide that international communications income also includes income derived from communications activity when the taxpayer is paid to transmit foreign-originating communications (communications with a beginning point in a foreign country or a possession of the United States) from a point in space or international water to a point in the United States. Also, a new example has been added to §1.863-9(j) of the final regulations to illustrate the changes made in the final regulations with respect to foreign-originating communications.

The changes made in the final regulations only affect communications that originate in a foreign country (or a possession of the United States) and does not affect communications that originate in space, international water, or the United States. The

Treasury Department and the IRS continue to believe that communications activity is most appropriately characterized based on the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication.

3. Determining the source of communications income based on functions performed, resources employed, or risks assumed in a foreign country or countries

As discussed above, the proposed regulations provided that the source of communications income is largely dependant on the type of communications activity and the citizenship or residence of the taxpayer. However, the proposed regulations provided for two instances where (in addition to the type of communications activity and the citizenship or residence of the taxpayer) the source of communications income may depend on functions performed, resources employed, or risks assumed. First, the proposed regulations provided that international communications income derived by a foreign person, other than a CFC, that is attributable to an office or other fixed place of business of the foreign person in the United States is U.S. source income. The proposed regulations provided that international communications income is attributable to an office or other fixed place of business to the extent of functions performed, resources employed, or risks assumed by the office or other fixed place of business. Second, the proposed regulations provided that international communications income derived by a foreign person, other than a CFC, engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

Commentators suggested that the final regulations also provide for similar rules that would source communications income as foreign source income based on functions performed, resources employed, or risks assumed in a foreign country or countries. For example, one commentator suggested that the source of international and U.S. communications income derived by any United States or foreign person (including branches, partnerships, and disregarded entities) engaged in a trade or business in a foreign country or countries is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in such foreign country or countries.

While the Treasury Department and the IRS recognize that commentators' suggestion to provide for a source rule based on functions performed, resources employed, or risks assumed in a foreign country or countries is reasonable, as explained below, the Treasury Department and the IRS believe that the statute and legislative history preclude such an option.

a. International Communications Income

Consistent with section 863(e)(1)(A), proposed §1.863-9(b)(1) provided that international communications income of a United States person is 50 percent U.S. source income and 50 percent foreign source income. One commentator suggested that it may be appropriate, in certain situations, to depart from the 50/50 source rule to provide special rules for foreign activities. According to the commentator, as a result of local regulatory requirements, U.S.-based international telecommunications providers often need to conduct portions of their international business through locally formed

entities, and such entities are fully subject to foreign tax on their income. The commentator therefore concluded that a source rule for international communications income based on functions performed, resources employed, or risks assumed in a foreign country or countries is not only equitable but also consistent with treatment accorded to foreign persons having a U.S. fixed place of business or engaged in a U.S. trade or business.

The Treasury Department and the IRS recognize that a source rule based on functions performed, resources employed, or risks assumed may be a reasonable alternative to the 50/50 source rule. Nonetheless, they continue to believe that the 50/50 source rule is the method that must be used to determine the source of a United States person's international communications income. This is because section 863(e)(1)(A) provides for an explicit 50/50 source rule for those persons without exception. In contrast, section 863(e)(1)(B) provides that a foreign person's international communications income is generally sourced outside the United States, except as provided in regulations. The Treasury Department and the IRS believe that the express grant of regulatory authority in the case of foreign persons and the omission of any such authority in the case of United States persons indicate that Congress intended the 50/50 sourcing rule be applied to United States persons without regulatory modification. There is nothing in the statute or legislative history that clearly demonstrates a different intention. In contrast, section 863(e)(1)(B)(ii) provides for a special source rule with respect to foreign persons with an office or other fixed place of business in the United States. A similar rule is not provided with respect to a United

States person's foreign activities. Thus, Congress chose a rule that sourced international communications income of foreign persons in certain instances based on the place of their activities, but expressly chose the 50/50 method to source international communications income of United States persons, regardless of the place of their activities.

The Treasury Department and the IRS recognize that the statute does not require strict application of the 50/50 source rule for CFCs. Section 863(e)(1)(B) only provides that the international communications income of a foreign person is foreign source income, except as provided in regulations. Consistent with and in light of this regulatory authority, however, the Treasury Department and the IRS believe that the 50/50 source rule is the most appropriate method to determine the source of a CFC's international communications income. This approach addresses the concern of the Treasury Department and the IRS that United States persons may use CFCs to obtain benefits that are inconsistent with the purposes of section 863(e). Consequently, the rules for determining the source of international communications income derived by a CFC should be the same as the rules for determining the source of such income if it is derived by a United States person. In addition, the Treasury Department and the IRS believe that the 50/50 source rule for CFCs, as opposed to the 100 percent U.S. source rule that was originally proposed as part of the 2001 proposed regulations, should limit the potential for multiple levels of taxation that commentators raised with respect to those prior proposed regulations.

b. U.S. Communications Income

Section 1.863-9(c) of the proposed regulations provided that income derived by a United States or foreign person from U.S. communications activity is entirely from sources within the United States. One commentator noted that a foreign person deriving income from the transmission of communications between a point in the United States and another point in the United States or between a point in the United States and a point in space or international water has 100 percent U.S. source income, even if much or all of the activity involved is outside the United States. In contrast, under the space and ocean rules, a foreign person has U.S. source income only to the extent the income is attributable to functions performed, resources employed, or risks assumed within the United States. Commentators therefore suggested modification of the 100 percent U.S. source rule for U.S. communications income derived by United States and foreign persons to take into account foreign activities.

The Treasury Department and the IRS recognize that a source rule based on functions performed, resources employed, or risks assumed may be a reasonable alternative to the 100 percent U.S. source rule for U.S. communications. Nonetheless, the Treasury Department and the IRS believe that Congress did not intend such an option. The legislative history indicates that if a communication is between two points within the United States, the “income attributable thereto is to be sourced entirely as U.S. source income.” S. REP. NO. 99–313, 1986-3 C.B. 359 (emphasis added). Congress intended such a result “even if the communication is routed through a satellite located in space, regardless of the satellite’s location.” *Id.* Thus, the legislative history clearly provides that Congress intended that U.S. communications income be sourced

entirely as U.S. source income.

4. International communications income derived by a foreign person (other than a CFC)

Proposed §1.863-9(b)(2) reflected the general rule under section 863(e)(1)(B) that a foreign person's international communications income is foreign source income. Consistent with the statutory exception under section 863(e)(1)(B)(ii), proposed §1.863-9(b)(2)(iii) provided that any international communications income derived by a foreign person, other than a CFC, that is attributable to an office or other fixed place of business of the foreign person in the United States is U.S. source income. International communications income is attributable to an office or other fixed place of business to the extent of functions performed, resources employed, or risks assumed by the office or other fixed place of business. Pursuant to the grant of regulatory authority under section 863(e)(1)(B), the proposed regulations provided other exceptions to the general rule for foreign persons. The first exception is the 50/50 source rule for CFCs under §1.863-9(b)(2)(ii) of the proposed regulations, as discussed above. The second exception was provided in §1.863-9(b)(2)(iv) of the proposed regulations and applied to foreign persons other than CFCs. Section 1.863-9(b)(2)(iv) of the proposed regulations provided that international communications income derived by a foreign person, other than a CFC, engaged in a trade or business within the United States, that is attributable to functions performed, resources employed, or risks assumed within the United States is U.S. source income. One commentator noted that it is unclear why a separate rule is needed for a fixed place of business in the United States and a U.S. trade or business because international communications income attributable to a fixed place of business

in the United States should also be attributable to functions performed, resources employed and risks assumed within the United States.

As indicated, the office or other fixed place of business rule under §1.863-9(b)(2)(iii) of the proposed regulations was derived from the statutory language of section 863(e), while the trade or business rule under §1.863-9(b)(2)(iv) of the proposed regulations was derived from the express grant of regulatory authority to source international communications income of foreign persons as other than foreign source. The Treasury Department and the IRS recognize that in most situations, the latter trade or business rule would indeed subsume the former fixed place of business rule, but still believe that the later rule serves an important function. The trade or business rule addresses the concern of the Treasury Department and the IRS that a foreign person could avoid a U.S. fixed place of business under section 863(e)(1)(B)(ii), yet engage in significant communications activity in the United States. The Treasury Department and the IRS believe that Congress intended that a foreign person engaged in substantial business in the United States be subject to U.S. tax on that communications activity.

5. Allocations

Section 1.863-9(h)(1)(ii) of the proposed regulations provided that to the extent that a taxpayer's transaction consists in part of non-de minimis communications activity and in part of non-de minimis non-communications activity, each part of the transaction must be treated as a separate transaction. Gross income is then allocated to each communications activity transaction and each non-communications activity transaction to the extent the income, based on all the facts and circumstances, is attributable to

functions performed, resources employed, or risks assumed in each such activity. Moreover, the Treasury Department and the IRS suggested in the preamble to the proposed regulations that allocations of gross income should be based generally on section 482 principles. One commentator stated that the complexities inherent in allocating income, based on section 482 principles, between the separated transactions are significant.

While the final regulations were not changed in response to this comment, as in the case of allocations for space and ocean income, the Treasury Department and the IRS believe that some clarification is warranted. In suggesting the use of section 482 principles as a guide, the Treasury Department and the IRS intend for taxpayers to adopt a reasonable approach to the allocations required in this area. Taxpayers know their businesses and will generally be in the best position to fashion a reasonable method that most reliably reflects the relative value of functions performed, resources employed, and risks assumed in different locations. In the preamble to the proposed regulations, the Treasury Department and the IRS solicited comments on alternative methods of allocation for particular industries and criteria that could be used to evaluate the reasonableness of such methods. No such comments were received. One commentator noted, however, that the proposed regulations perhaps reflected what taxpayers in these industries have already been doing in order to determine the character and source of their communications income. Consequently, as in the case of space and ocean income, the Treasury Department and the IRS believe that allocations of gross income based on functions performed, resources employed, and risks

assumed are appropriate in these circumstances.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment pursuant to that Order is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules provided in these regulations principally affect large multinational corporations that pay foreign taxes on income derived from substantial foreign operations and that use these and any other applicable source rules in determining their foreign tax credit. Accordingly, a Regulatory Flexibility Act assessment is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the NPRM preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is H. Michael Huynh of the Office of the Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.863-8 also issued under 26 U.S.C. 863(a), (b) and (d). * * *

Section 1.863-9 also issued under 26 U.S.C. 863(a), (d) and (e). * * *

Par. 2. Section 1.863-3 is amended by:

1. Adding a sentence after the first sentence in paragraph (a)(1).
2. Adding a sentence at the end of paragraph (c)(1)(i)(A).
3. Adding a sentence after the first sentence in paragraph (c)(2).

The additions read as follows:

§1.863-3 Allocation and apportionment of income from certain sales of inventory.

(a) * * * (1) * * * To determine the source of income from sales of property produced by the taxpayer, when the property is either produced in whole or in part in space or on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (in international water), or is sold in space or international water, the rules of §1.863-8

apply, and the rules of this section do not apply except to the extent provided in §1.863-8. * * *

* * * * *

(c) * * * (1) * * * (i) * * * (A) * * * For rules regarding the source of income when production takes place, in whole or in part, in space or international water, the rules of §1.863-8 apply, and the rules of this section do not apply except to the extent provided in §1.863-8.

* * * * *

(2) * * * Notwithstanding any other provision, for rules regarding the source of income when a sale takes place in space or international water, the rules of §1.863-8 apply, and the rules of this section do not apply except to the extent provided in §1.863-8. * * *

* * * * *

Par. 3. Sections 1.863-8 and 1.863-9 are added to read as follows:

§1.863-8 Source of income derived from space and ocean activity under section 863(d).

(a) In general. Income of a United States or a foreign person derived from space and ocean activity (space and ocean income) is sourced under the rules of this section, notwithstanding any other provision, including sections 861, 862, 863, and 865. A taxpayer will not be considered to derive income from space or ocean activity, as defined in paragraph (d) of this section, if such activity is performed by another person, subject to the rules for the treatment of consolidated groups in §1.1502-13.

(b) Source of gross income from space and ocean activity--(1) Space and ocean income derived by a United States person. Space and ocean income derived by a United States person is income from sources within the United States. However, space and ocean income derived by a United States person is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(2) Space and ocean income derived by a foreign person--(i) In general. Space and ocean income derived by a person other than a United States person is income from sources without the United States, except as otherwise provided in this paragraph (b)(2).

(ii) Space and ocean income derived by a controlled foreign corporation. Space and ocean income derived by a controlled foreign corporation within the meaning of section 957 (CFC) is income from sources within the United States. However, space and ocean income derived by a CFC is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(iii) Space and ocean income derived (iii) by foreign persons engaged in a trade or business within the United States. Space and ocean income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the

facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(3) Source rules for income from certain sales of property--(i) Sales of purchased property. When a taxpayer sells purchased property in space or international water, the source of gross income from the sale generally will be determined under paragraph (b)(1) or (2) of this section, as applicable. However, if such property is inventory property within the meaning of section 1221(a)(1) (inventory property) and is sold for use, consumption, or disposition outside space and international water, the source of income from the sale will be determined under §1.861-7(c).

(ii) Sales of property produced by the taxpayer--(A) General. If the taxpayer both produces property and sells such property, the taxpayer must allocate gross income from such sales between production activity and sales activity under the 50/50 method. Under the 50/50 method, one-half of the taxpayer's gross income will be considered income allocable to production activity, and the source of that income will be determined under paragraph (b)(3)(ii)(B) or (C) of this section. The remaining one-half of such gross income will be considered income allocable to sales activity, and the source of that income will be determined under paragraph (b)(3)(ii)(D) of this section.

(B) Production only in space or international water, or only outside space and international water. When production occurs only in space or international water, income allocable to production activity is sourced under paragraph (b)(1) or (2) of this section, as applicable. When production occurs only outside space and international

water, income allocable to production activity is sourced under §1.863-3(c)(1).

(C) Production both in space or international water and outside space and international water. When property is produced both in space or international water and outside space and international water, gross income allocable to production activity must be allocated to production occurring in space or international water and production occurring outside space and international water. Such gross income is allocated to production activity occurring in space or international water to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water. The balance of such gross income is allocated to production activity occurring outside space and international water. The source of gross income allocable to production activity in space or international water is determined under paragraph (b)(1) or (2) of this section, as applicable. The source of gross income allocated to production activity occurring outside space and international water is determined under §1.863-3(c)(1).

(D) Source of income allocable to sales activity. When property produced by the taxpayer is sold outside space and international water, the source of gross income allocable to sales activity will be determined under §§1.861-7(c) and 1.863-3(c)(2). When property produced by the taxpayer is sold in space or international water, the source of gross income allocable to sales activity generally will be determined under paragraph (b)(1) or (2) of this section, as applicable. However, if such property is inventory property within the meaning of section 1221(a)(1) and is sold in space or international water for use, consumption, or disposition outside space, international

water, and the United States, the source of gross income allocable to sales activity will be determined under §§1.861-7(c) and 1.863-3(c)(2).

(4) Special rule for determining the source of gross income from services. To the extent a transaction characterized as the performance of a service constitutes a space or ocean activity, as determined under paragraph (d)(2)(ii) of this section, the source of gross income derived from such transaction is determined under paragraph (b)(1) or (2) of this section.

(5) Special rule for determining source of income from communications activity (other than income from international communications activity). Space and ocean activity, as defined in paragraph (d) of this section, includes activity that occurs in space or international water that is characterized as a communications activity as defined in §1.863-9(h)(1) (other than international communications activity). The source of space and ocean income that is also communications income as defined in §1.863-9(h)(2) (but not space/ocean communications income as defined in §1.863-9(h)(3)(v)) is determined under the rules of §1.863-9(c), (d), and (f), as applicable, rather than under paragraph (b) of this section. The source of space and ocean income that is also space/ocean communications income as defined in §1.863-9(h)(3)(v) is determined under the rules of paragraph (b) of this section. See §1.863-9(e).

(c) Taxable income. When a taxpayer allocates gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section, the taxpayer must allocate expenses, losses, and other deductions as prescribed in §§1.861-8 through 1.861-14T to the class or classes of gross income that include the income so allocated in each case. A

taxpayer must then apply the rules of §§1.861-8 through 1.861-14T to apportion properly amounts of expenses, losses, and other deductions so allocated to such gross income between gross income from sources within the United States and gross income from sources without the United States.

(d) Space and ocean activity--(1) Definition--(i) Space activity. In general, space activity is any activity conducted in space. For purposes of this section, space means any area not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States, and not in international water. For purposes of determining space activity, the Commissioner may separate parts of a single transaction into separate transactions or combine separate transactions as part of a single transaction. Paragraph (d)(3) of this section lists specific exceptions to the general definition of space activity. Activities that constitute space activity include but are not limited to--

(A) Performance and provision of services in space, as defined in paragraph (d)(2)(ii) of this section;

(B) Leasing of equipment located in space, including spacecraft (for example, satellites) or transponders located in space;

(C) Licensing of technology or other intangibles for use in space;

(D) Production, processing, or creation of property in space, as defined in paragraph (d)(2)(i) of this section;

(E) Activity occurring in space that is characterized as communications activity (other than international communications activity) under §1.863-9(h)(1);

(F) Underwriting income from the insurance of risks on activities that produce space income; and

(G) Sales of property in space (see §1.861-7(c)).

(ii) Ocean activity. In general, ocean activity is any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (collectively, in international water). For purposes of determining ocean activity, the Commissioner may separate parts of a single transaction into separate transactions or combine separate transactions as part of a single transaction. Paragraph (d)(3) of this section lists specific exceptions to the general definition of ocean activity. Activities that constitute ocean activity include but are not limited to--

(A) Performance and provision of services in international water, as defined in paragraph (d)(2)(ii) of this section;

(B) Leasing of equipment located in international water, including underwater cables;

(C) Licensing of technology or other intangibles for use in international water;

(D) Production, processing, or creation of property in international water, as defined in paragraph (d)(2)(i) of this section;

(E) Activity occurring in international water that is characterized as communications activity (other than international communications activity) under §1.863-9(h)(1);

(F) Underwriting income from the insurance of risks on activities that produce

ocean income;

(G) Sales of property in international water (see §1.861-7(c));

(H) Any activity performed in Antarctica;

(I) The leasing of a vessel that does not transport cargo or persons for hire between ports-of-call (for example, the leasing of a vessel to engage in research activities in international water); and

(J) The leasing of drilling rigs, extraction of minerals, and performance and provision of services related thereto, except as provided in paragraph (d)(3)(ii) of this section.

(2) Determining a space or ocean activity--(i) Production of property in space or international water. For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages property within the meaning of section 864(a) and §1.864-1.

(ii) Special rule for performance of services--(A) General. Except as provided in paragraph (d)(2)(ii)(B) of this section, if a transaction is characterized as the performance of a service, then such service will be treated as a space or ocean activity in its entirety when any part of the service is performed in space or international water. Services are performed in space or international water if functions are performed, resources are employed, or risks are assumed in space or international water, regardless of whether performed by personnel, equipment, or otherwise.

(B) Exception to the general rule. If the taxpayer can demonstrate the value of the service attributable to performance occurring in space or international water, and the

value of the service attributable to performance occurring outside space and international water, then such service will be treated as space or ocean activity only to the extent of the activity performed in space or international water. The value of the service is attributable to performance occurring in space or international water to the extent the performance of the service, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water. In addition, if the taxpayer can demonstrate, based on all the facts and circumstances, that the value of the service attributable to performance in space and international water is de minimis, such service will not be treated as space or ocean activity.

(3) Exceptions to space or ocean activity. Space or ocean activity does not include the following types of activities:

(i) Any activity giving rise to transportation income as defined in section 863(c).

(ii) Any activity with respect to mines, oil and gas wells, or other natural deposits, to the extent the mines, wells, or natural deposits are located within the jurisdiction (as recognized by the United States) of any country, including the United States and its possessions.

(iii) Any activity giving rise to international communications income as defined in §1.863-9(h)(3)(ii).

(e) Treatment of partnerships. This section is applied at the partner level.

(f) Examples. The following examples illustrate the rules of this section:

Example 1. Space activity--activity occurring on land and in space--(i) Facts. S, a United States person, owns satellites in orbit. S leases one of its satellites to A. S, as

lessor, will not operate the satellite. Part of S's performance as lessor in this transaction occurs on land. Assume that the combination of S's activities is characterized as the lease of equipment.

(ii) Analysis. Because the leased equipment is located in space, the transaction is defined in its entirety as space activity under paragraph (d)(1)(i) of this section. Income derived from the lease will be sourced under paragraph (b)(1) of this section. Under paragraph (b)(1) of this section, S's space income is sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

Example 2. Space activity--(i) Facts. X is an Internet service provider. X offers a service that permits a customer (C) to connect to the Internet via a telephone call, initiated by the modem of C's personal computer, to a control center. X transmits information requested by C to C's personal computer, in part using satellite capacity leased by X from S. X performs the uplink and downlink functions. X charges its customers a flat monthly fee. Assume that neither X nor S derive international communications income within the meaning of §1.863-9(h)(3)(ii). In addition, assume that X is able to demonstrate, pursuant to paragraph (d)(2)(ii)(B) of this section, the extent to which the value of the service is attributable to functions performed, resources employed, and risks assumed in space.

(ii) Analysis. Under paragraph (d)(2)(ii) of this section, the service performed by X constitutes space activity to the extent the value of the service is attributable to functions performed, resources employed, and risks assumed in space. To the extent the service performed by X constitutes space activity, the source of X's income from the service transaction is determined under paragraph (b) of this section. To the extent the service performed by X does not constitute space or ocean activity, the source of X's income from the service is determined under sections 861, 862, and 863, as applicable. To the extent that X derives space and ocean income that is also communications income within the meaning of §1.863-9(h)(2), the source of X's income is determined under paragraph (b) of this section and §1.863-9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. S derives space and ocean income that is also communications income within the meaning of §1.863-9(h)(2), and the source of S's income is therefore determined under paragraph (b) of this section and §1.863-9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section.

Example 3. Services as space activity--de minimis value attributable to performance occurring in space--(i) Facts. R owns a retail outlet in the United States. R engages S to provide a security system for R's premises. S operates its security system by transmitting images from R's premises directly to a satellite, and from the satellite to a group of S employees located in Country B, who monitor the premises by viewing the transmitted images. The satellite is used as a medium of delivery and not

as a method of surveillance. O provides S with transponder capacity on O's satellite, which S uses to transmit those images. Assume that S's transaction with R is characterized as the performance of a service. Assume that O's provision of transponder capacity is also viewed as the provision of a service. Assume also that S is able to demonstrate, pursuant to §1.863-9(h)(1), that the value of the transaction with R attributable to communications activities is de minimis.

(ii) Analysis. S derives income from providing monitoring services. S can demonstrate, pursuant to paragraph (d)(2)(ii) of this section, that based on all the facts and circumstances, the value of S's service transaction attributable to performance in space is de minimis. Thus, S is not treated as engaged in a space activity, and none of S's income from the service transaction is space income. In addition, because S demonstrates that the value of the transaction with R attributable to communications activities is de minimis, S is not required under §1.863-9(h)(1)(ii) to treat the transaction as separate communications and non-communications transactions, and none of S's gross income from the transaction is treated as communications income within the meaning of §1.863-9(h)(2). O's provision of transponder capacity is viewed as the provision of a service. Based on all the facts and circumstances, the value of O's service transaction attributable to performance in space is not de minimis. Thus, O's activity will be considered space activity, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of the services transaction is attributable to performance in space (unless O's activity in space is international communications activity). To the extent that O derives communications income, the source of such income is determined under paragraph (b) of this section and §1.863-9(b), (c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. R does not derive any income from space activity.

Example 4. Space activity--(i) Facts. L, a domestic corporation, offers programming and certain other services to customers located both in the United States and in foreign countries. Assume that L's provision of programming and other services in this Example 4 is characterized as the provision of a service, and that no part of the service transaction occurs in space or international water. Assume that the delivery of the programming constitutes a separate transaction also characterized as the performance of a service. L uses satellite capacity acquired from S to deliver the programming service directly to customers' television sets. L performs the uplink and downlink functions, so that part of the value of the delivery transaction derives from functions performed and resources employed in space. Assume that these contributions to the value of the delivery transaction occurring in space are not considered de minimis under paragraph (d)(2)(ii)(B) of this section. Customer C pays L to provide and deliver programming to C's residence in the United States. Assume S's provision of satellite capacity in this Example 4 is viewed as the provision of a service, and also that S does not derive international communications income within the meaning of §1.863-9(h)(3)(ii).

(ii) Analysis. S's activity will be considered space activity. To the extent that S

derives space and ocean income that is also communications income under §1.863-9(h)(2), the source of S's income is determined under paragraph (b) of this section and §1.863-9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. On these facts, L's activities are treated as two separate service transactions: the provision of programming (and other services), and the delivery of programming. L's income derived from provision of programming and other services is not income derived from space activity. L's delivery of programming and other services is considered space activity, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of the delivery transaction is attributable to performance in space. To the extent that the delivery of programming is treated as a space activity, the source of L's income derived from the delivery transaction is determined under paragraph (b)(1) of this section, as provided in paragraph (b)(4) of this section. To the extent that L derives space and ocean income that is also communications income within the meaning of §1.863-9(h)(2), the source of such income is determined under paragraph (b) of this section and §1.863-9(b), (c), (d), (e), and (f), as applicable, as provided in paragraph (b)(5) of this section.

Example 5. Space activity--(i) Facts. The facts are the same as in Example 4, except that L does not deliver the programming service directly but instead engages R, a domestic corporation specializing in content delivery, to deliver by transmission its programming. For all portions of a transmission which require satellite capacity, R, in turn, contracts out such functions to S. S performs the uplink and downlink functions, so that part of the value of the delivery transaction derives from functions performed and resources employed in space.

(ii) Analysis. L's activity will not be considered space activity because none of L's activity occurs in space. Thus, L does not derive any space and ocean income. L does, however, derive communications income within the meaning of §1.863-9(h)(2). This is the case even though L does not perform the transmission function because L is paid by Customer C to transmit, and bears the risk of transmitting, the communications or data. To the extent that L's activity consists in part of non-de minimis communications and non-de minimis non-communications activity, each part of the transaction must be treated as a separate transaction and gross income is allocated accordingly under § 1.863-9(h)(1)(ii). In addition, L must also allocate expenses, losses, and other deductions, for example, payments to R, to the class or classes of gross income that include the income so allocated. R's activity will not be considered space activity. Since R contracts out all of the functions involving satellite capacity to S, no part of R's activity occurs in space. Thus, R does not derive any space and ocean income. R does, however, derive communications income within the meaning of §1.863-9(h)(2). This is the case even though R does not perform the transmission function because R is paid by L to transmit, and bears the risk of transmitting, the communications or data. S's activity will be considered space activity. To the extent that S derives space and ocean income that is also communications income within the meaning of §1.863-9(h)(2), the source of such income is determined under paragraph

(b) of this section and §1.863-9(b), (c), (d), (e), and (f), as applicable, as provided in paragraph (b)(5) of this section.

Example 6. Space activity--treatment of land activity--(i) Facts. S, a United States person, offers remote imaging products and services to its customers. In year 1, S uses its satellite's remote sensors to gather data on certain geographical terrain. In year 3, C, a construction development company, contracts with S to obtain a satellite image of an area for site development work. S pulls data from its archives and transfers to C the images gathered in year 1, in a transaction that is characterized as a sale of the data. S's rights, title, and interest in the data pass to C in the United States. Before transferring the images to C, S uses computer software in its land-based office to enhance the images so that the images can be used.

(ii) Analysis. The collection of data and creation of images in space is characterized as the creation of property in space. Because S both produces and sells the data, S must allocate gross income from the sale of the data between production activity and sales activity under the 50/50 method of paragraph (b)(3)(ii)(A). The source of S's income allocable to production activity is determined under paragraph (b)(3)(ii)(C) of this section because production activities occur both in space and on land. The source of S's income attributable to sales activity is determined under paragraph (b)(3)(ii)(D) of this section (by reference to §1.863-3(c)(2)) as U.S. source income because S's rights, title, and interest in the data pass to C in the United States.

Example 7. Use of intangible property in space--(i) Facts. X acquires a license to use a particular satellite slot or orbit, which X sublicenses to C. C pays X a royalty.

(ii) Analysis. Because the royalty is paid for the right to use intangible property in space, the source of the royalty paid by C to X is determined under paragraph (b) of this section.

Example 8. Performance of services--(i) Facts. E, a domestic corporation, operates satellites with sensing equipment that can determine how much heat and light particular plants emit and reflect. Based on the data, E will provide F, a U.S. farmer, a report analyzing the data, which F will use in growing crops. E analyzes the data from offices located in the United States. Assume that E's combined activities are characterized as the performance of services.

(ii) Analysis. Based on all the facts and circumstances, the value of E's service transaction attributable to performance in space is not de minimis. Thus, E's activities will be considered space activities, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of E's service transaction is attributable to performance in space. To the extent E's service transaction constitutes a space activity, the source of E's income derived from the service transaction will be determined under paragraph (b)(4) of this section, by reference to paragraph (b)(1) of this section. To the extent that E's service

transaction does not constitute a space or ocean activity, the source of E's income derived from the service transaction is determined under sections 861, 862, and 863, as applicable.

Example 9. Separate transactions--(i) Facts. The same facts as Example 8, except that E provides the raw data to F in a transaction characterized as a sale of a copyrighted article. In addition, E provides an analysis in the form of a report to F. The price F pays E for the raw data is separately stated.

(ii) Analysis. To the extent that the provision of raw data and the analysis of the data are each treated as separate transactions, the source of income from the production and sale of data is determined under paragraph (b)(3)(ii) of this section. The provision of services would be analyzed in the same manner as in Example 8.

Example 10. Sale of property in international water--(i) Facts. T purchased and owns transatlantic cable that lies in international water. T sells the cable to B, with T's rights, title, and interest in the cable passing to B in international water. Assume that the transatlantic cable is not inventory property within the meaning of section 1221(a)(1).

(ii) Analysis. Because T's rights, title, and interest in the property pass to B in international water, the sale takes place in international water under §1.861-7(c), and the sale transaction is ocean activity under paragraph (d)(1)(ii) of this section. The source of T's sales income is determined under paragraph (b)(3)(i) of this section, by reference to paragraph (b)(1) or (2) of this section.

Example 11. Sale of property in space--(i) Facts. S, a United States person, manufactures a satellite in the United States and sells it to a customer who is not a United States person. S's rights, title, and interest in the satellite pass to the customer in space.

(ii) Analysis. Because S's rights, title, and interest in the satellite pass to the customer in space, the sale takes place in space under §1.861-7(c), and the sale transaction is space activity under paragraph (d)(1)(i) of this section. The source of income derived from the sale of the satellite in space is determined under paragraph (b)(3)(ii) of this section, with the source of income allocable to production activity determined under paragraphs (b)(3)(ii)(A) and (B) of this section, and the source of income allocable to sales activity determined under paragraphs (b)(3)(ii)(A) and (D) of this section. Under paragraph (b)(1) of this section, S's space income is sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

Example 12. Sale of property in space--(i) Facts. S has a right to operate from

a particular position (satellite slot or orbit) in space. S sells the right to operate from that position to P. Assume that the sale of the satellite slot is characterized as a sale of property and that S's rights, title, and interest in the satellite slot pass to P in space.

(ii) Analysis. The sale of the satellite slot takes place in space under §1.861-7(c) because S's rights, title, and interest in the satellite slot pass to P in space. The sale of the satellite slot is space activity under paragraph (d)(1)(i) of this section, and income or gain from the sale is sourced under paragraph (b)(3)(i) of this section, by reference to paragraph (b)(1) or (2) of this section.

Example 13. Source of income of a foreign person--(i) Facts. FP, a foreign corporation that is not a CFC, derives income from the operation of satellites. FP operates ground stations in the United States and in foreign Country FC. Assume that FP is considered engaged in a trade or business within the United States based on FP's operation of the ground station in the United States.

(ii) Analysis. Under paragraph (b)(2)(iii) of this section, FP's space income is sourced in the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

Example 14. Source of income of a foreign person--(i) Facts. FP, a foreign corporation that is not a CFC, operates remote sensing satellites in space to collect data and images for its customers. FP uses an independent agent, A, in the United States who provides marketing, order-taking, and other customer service functions. Assume that FP is considered engaged in a trade or business within the United States based on A's activities on FP's behalf in the United States.

(ii) Analysis. Under paragraph (b)(2)(iii) of this section, FP's space income is sourced in the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(g) Reporting and documentation requirements--(1) In general. A taxpayer making an allocation of gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section must satisfy the requirements in paragraphs (g)(2), (3), and (4) of this section.

(2) Required documentation. In all cases, a taxpayer must prepare and maintain documentation in existence when its return is filed regarding the allocation of gross

income and allocation and apportionment of expenses, losses, and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must make available such documentation within 30 days upon request.

(3) Access to software. If the taxpayer or any third party used any computer software, within the meaning of section 7612(d), to allocate gross income, or to allocate or apportion expenses, losses, and other deductions, the taxpayer must make available upon request--

(i) Any computer software executable code, within the meaning of section 7612(d), used for such purposes, including an executable copy of the version of the software used in the preparation of the taxpayer's return (including any plug-ins, supplements, etc.) and a copy of all related electronic data files. Thus, if software subsequently is upgraded or supplemented, a separate executable copy of the version used in preparing the taxpayer's return must be retained;

(ii) Any related computer software source code, within the meaning of section 7612(d), acquired or developed by the taxpayer or a related person, or primarily for internal use by the taxpayer or such person rather than for commercial distribution; and

(iii) In the case of any spreadsheet software or similar software, any formulae or links to supporting worksheets.

(4) Use of allocation methodology. In general, when a taxpayer allocates gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section, it does so by making the allocation on a timely filed original return (including extensions). However, a taxpayer will be permitted to make changes to such allocations made on its original return with respect to any taxable year for which the statute of limitations has not closed as follows:

(i) In the case of a taxpayer that has made a change to such allocations prior to the opening conference for the audit of the taxable year to which the allocation relates or who makes such a change within 90 days of such opening conference, if the IRS issues a written information document request asking the taxpayer to provide the documents and such other information described in paragraphs (g)(2) and (3) of this section with respect to the changed allocations and the taxpayer complies with such request within 30 days of the request, then the IRS will complete its examination, if any, with respect to the allocations for that year as part of the current examination cycle. If the taxpayer does not provide the documents and information described in paragraphs (g)(2) and (3) of this section within 30 days of the request, then the procedures described in paragraph (g)(4)(ii) of this section shall apply.

(ii) If the taxpayer changes such allocations more than 90 days after the opening conference for the audit of the taxable year to which the allocations relate or the taxpayer does not provide the documents and information with respect to the changed allocations as requested in accordance with paragraphs (g)(2) and (3) of this section, then the IRS will, in a separate cycle, determine whether an examination of the taxpayer's allocations is warranted and complete any such examination. The separate cycle will be worked as resources are available and may not have the same estimated completion date as the other issues under examination for the taxable year. The IRS may ask the taxpayer to extend the statute of limitations on assessment and collection for the taxable year to permit examination of the taxpayer's method of allocation, including an extension limited, where appropriate, to the taxpayer's method of allocation.

(h) Effective date. This section applies to taxable years beginning on or after

December 27, 2006.

§1.863-9 Source of income derived from communications activity under section 863(a), (d), and (e).

(a) In general. Income of a United States or a foreign person derived from each type of communications activity, as defined in paragraph (h)(3) of this section, is sourced under the rules of this section, notwithstanding any other provision including sections 861, 862, 863, and 865. Notwithstanding that a communications activity would qualify as space or ocean activity under section 863(d) and the regulations thereunder, the source of income derived from such communications activity is determined under this section, and not under section 863(d) and the regulations thereunder, except to the extent provided in §1.863-8(b)(5).

(b) Source of international communications income--(1) International communications income derived by a United States person. Income derived from international communications activity (international communications income) by a United States person is one-half from sources within the United States and one-half from sources without the United States.

(2) International communications income derived by foreign persons--(i) In general. International communications income derived by a person other than a United States person is, except as otherwise provided in this paragraph (b)(2), wholly from sources without the United States.

(ii) International communications income derived by a controlled foreign corporation. International communications income derived by a controlled foreign

corporation within the meaning of section 957 (CFC) is one-half from sources within the United States and one-half from sources without the United States.

(iii) International communications income derived by foreign persons with a fixed place of business in the United States. International communications income derived by a foreign person, other than a CFC, that is attributable to an office or other fixed place of business of the foreign person in the United States is from sources within the United States. The principles of section 864(c)(5) apply in determining whether a foreign person has an office or fixed place of business in the United States. See §1.864-7. International communications income is attributable to an office or other fixed place of business to the extent of functions performed, resources employed, or risks assumed by the office or other fixed place of business.

(iv) International communications income derived by foreign persons engaged in a trade or business within the United States. International communications income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(c) Source of U.S. communications income. Income derived by a United States or foreign person from U.S. communications activity is from sources within the United States.

(d) Source of foreign communications income. Income derived by a United States or foreign person from foreign communications activity is from sources without

the United States.

(e) Source of space/ocean communications income. The source of income derived by a United States or foreign person from space/ocean communications activity is determined under section 863(d) and the regulations thereunder.

(f) Source of communications income when taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication. Income derived by a United States or foreign person from communications activity, when the taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication as required in paragraph (h)(3)(i) of this section, is from sources within the United States.

(g) Taxable income. When a taxpayer allocates gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section, the taxpayer must allocate expenses, losses, and other deductions as prescribed in §§1.861-8 through 1.861-14T to the class or classes of gross income that include the income so allocated in each case. A taxpayer must then apply the rules of §§1.861-8 through 1.861-14T properly to apportion amounts of expenses, losses, and other deductions so allocated to such gross income between gross income from sources within the United States and gross income from sources without the United States. For amounts of expenses, losses, and other deductions allocated to gross income derived from international communications activity, when the source of income is determined under the 50/50 method of paragraph (b)(1) or (b)(2)(ii) of this section, taxpayers generally must apportion expenses, losses, and other deductions between sources within the United States and sources without the

United States pro rata based on the relative amounts of gross income from sources within the United States and gross income from sources without the United States. However, the preceding sentence shall not apply to research and experimental expenditures qualifying under §1.861-17, which are to be allocated and apportioned under the rules of that section.

(h) Communications activity and income derived from communications activity--

(1) Communications activity--(i) General rule. For purposes of this part, communications activity consists solely of the delivery by transmission of communications or data (communications). Delivery of communications other than by transmission (for example, by delivery of physical packages and letters) is not communications activity within the meaning of this section. Communications activity also includes the provision of capacity to transmit communications. Provision of content or any other additional service provided along with, or in connection with, a non-de minimis communications activity must be treated as a separate non-communications activity unless de minimis. Communications activity or non-communications activity will be treated as de minimis to the extent, based on the facts and circumstances, the value attributable to such activity is de minimis.

(ii) Separate transaction. To the extent that a taxpayer's transaction consists in part of non-de minimis communications activity and in part of non-de minimis non-communications activity, each such part of the transaction must be treated as a separate transaction. Gross income is allocated to each such communications activity transaction and non-communications activity transaction to the extent the income,

based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in each such activity.

(2) Income derived from communications activity. Income derived from communications activity (communications income) is income derived from the delivery by transmission of communications, including income derived from the provision of capacity to transmit communications. Income may be considered derived from a communications activity even if the taxpayer itself does not perform the transmission function, but in all cases, the taxpayer derives communications income only if the taxpayer is paid to transmit, and bears the risk of transmitting, the communications.

(3) Determining the type of communications activity--(i) In general. Whether income is derived from international communications activity, U.S. communications activity, foreign communications activity, or space/ocean communications activity is determined by identifying the two points between which the taxpayer is paid to transmit the communication. The taxpayer must establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication. Whether the taxpayer contracts out part or all of the transmission function is not relevant. A taxpayer may satisfy the requirement that the taxpayer establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication by using any consistently applied reasonable method to establish one or both endpoints. In evaluating the reasonableness of such method, consideration will be given to all the facts and circumstances, including whether the endpoints would otherwise be identifiable absent this reasonable method provision and the reliability of

the data. Depending on the facts and circumstances, methods based on, for example, records of port or transport charges, customer billing records, a satellite footprint, or records of termination fees made pursuant to an international settlement agreement may be reasonable. In addition, practices used by taxpayers to classify or categorize certain communications activity in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint ventures, or other parties or governmental agencies in interest may be reliable indicators of the reasonableness of the method chosen, but need not be accorded conclusive weight by the Commissioner. In all cases, the method chosen to establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication must be supported by sufficient documentation to permit verification by the Commissioner.

(ii) Income derived from international communications activity. Income derived by a taxpayer from international communications activity (international communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit--

(A) Between a point in the United States and a point in a foreign country (or a possession of the United States); or

(B) Foreign-originating communications (communications with a beginning point in a foreign country or a possession of the United States) from a point in space or international water to a point in the United States.

(iii) Income derived from U.S. communications activity. Income derived by a

taxpayer from U.S. communications activity (U.S. communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit--

(A) Between two points in the United States; or

(B) Between the United States and a point in space or international water, except as provided in paragraph (h)(3)(ii)(B) of this section.

(iv) Income derived from foreign communications activity. Income derived by a taxpayer from foreign communications activity (foreign communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit--

(A) Between two points in a foreign country or countries (or a possession or possessions of the United States);

(B) Between a foreign country and a possession of the United States; or

(C) Between a foreign country (or a possession of the United States) and a point in space or international water.

(v) Income derived from space/ocean communications activity. Income derived by a taxpayer from space/ocean communications activity (space/ocean communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit between a point in space or international water and another point in space or international water.

(i) Treatment of partnerships. This section is applied at the partner level.

(j) Examples. The following examples illustrate the rules of this section:

Example 1. Income derived from non-communications activity--remote data base access--(i) Facts. D provides its customers in various foreign countries with access to its data base, which contains information on certain individuals' health care insurance coverage. Customer C obtains access to D's data base by placing a call to D's telephone number. Assume that C's telephone service, used to access D's data base, is provided by a third party, and that D assumes no responsibility for the transmission of the information via telephone.

(ii) Analysis. D is not paid to transmit communications and does not derive income from communications activity within the meaning of paragraph (h)(2) of this section. Rather, D derives income from provision of content or provision of services to its customers. Therefore, the rules of this section do not apply to determine the source of D's income.

Example 2. Income derived from U.S. communications activity--U.S. portion of international communication--(i) Facts. TC, a local telephone company, receives an access fee from an international carrier for picking up a call from a local telephone customer and delivering the call to a U.S. point of presence (POP) of the international carrier. The international carrier picks up the call from its U.S. POP and delivers the call to a foreign country.

(ii) Analysis. TC is not paid to carry the transmission between the United States and a foreign country. TC is paid to transmit a communication between two points in the United States. TC derives U.S. communications income as defined in paragraph (h)(3)(iii) of this section, which is sourced under paragraph (c) of this section as U.S. source income.

Example 3. Income derived from international communications activity--underwater cable--(i) Facts. TC, a domestic corporation, owns an underwater fiber optic cable. Pursuant to contracts, TC makes available to its customers capacity to transmit communications via the cable. TC's customers then solicit telephone customers and arrange to transmit the telephone customers' calls. The cable runs in part through U.S. waters, in part through international waters, and in part through foreign country waters.

(ii) Analysis. TC derives international communications income as defined in paragraph (h)(3)(ii) of this section because TC is paid to make available capacity to transmit communications between the United States and a foreign country. Because TC is a United States person, TC's international communications income is sourced under paragraph (b)(1) of this section as one-half from sources within the United States and one-half from sources without the United States.

Example 4. Income derived from international communications activity--satellite--(i) Facts. S, a United States person, owns satellites in orbit and uplink facilities in Country X, a foreign country. B, a resident of Country X, pays S to deliver B's

programming from S's uplink facility, located in Country X, to a downlink facility in the United States owned by C, a customer of B.

(ii) Analysis. S derives international communications income under paragraph (h)(3)(ii) of this section because S is paid to transmit the communications between a beginning point in a foreign country and an endpoint in the United States. Because S is a United States person, the source of S's international communications income is determined under paragraph (b)(1) of this section as one-half from sources within the United States and one-half from sources without the United States.

Example 5. The paid-to-do rule--foreign communications via domestic route--(i) Facts. TC is paid to transmit communications from Toronto, Canada, to Paris, France. TC transmits the communications from Toronto to New York. TC pays another communications company, IC, to transmit the communications from New York to Paris.

(ii) Analysis. Under the paid-to-do rule of paragraph (h)(3)(i) of this section, TC derives foreign communications income under paragraph (h)(3)(iv) of this section because TC is paid to transmit communications between two points in foreign countries, Toronto and Paris. Under paragraph (h)(3)(i) of this section, the character of TC's communications activity is determined without regard to the fact that TC pays IC to transmit the communications for some portion of the delivery path. IC has international communications income under paragraph (h)(3)(ii) of this section because IC is paid to transmit the communications between a point in the United States and a point in a foreign country.

Example 6. The paid-to-do rule--domestic communication via foreign route--(i) Facts. TC is paid to transmit a call between two points in the United States, but routes the call through Canada.

(ii) Analysis. Under paragraph (h)(3)(i) of this section, the character of income derived from communications activity is determined by the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communications, without regard to the path of the transmission between those two points. Thus, under paragraph (h)(3)(iii) of this section, TC derives income from U.S. communications activity because it is paid to transmit the communications between two U.S. points.

Example 7. The paid-to-do rule--foreign-originating communications--(i) Facts. Under an international settlement agreement, G, a Country X international carrier, pays T to receive all calls originating in Country X that are bound for the United States and to terminate such calls in the United States. Due to Country X legal restrictions, the international settlement agreement specifies that G carries the transmission to a point outside the territory of Country X and that T carries the foreign-originating transmission from such point to the destined point in the United States. T, in turn, contracts out with another communications company, S, to transmit the U.S. portion of the

communications. Tracing and identifying the endpoints of each transmission is not possible or practical. T does, however, keep records of termination fees received from G for terminating the foreign-originating calls.

(ii) Analysis. T derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, T can establish that T is paid to transmit, and bears the risk of transmitting, foreign-originating calls from a point in space or international water to a point in the United States using a reasonable method to establish the endpoints, assuming that this method is consistently applied. In this case, T can reasonably establish that T is paid to receive foreign-originating calls and terminate such calls in the United States based on the records of termination fees pursuant to an international settlement agreement. Under paragraph (h)(3)(ii)(B) of this section, a taxpayer derives income from international communications activity when the taxpayer is paid to transmit foreign-originating communications from space or international water to the United States. Thus, under paragraph (h)(3)(ii)(B) of this section, T derives income from international communications. If, based on all the facts and circumstances, T could reasonably trace and identify the endpoints, then T would have to directly establish that each call originated in a foreign country. Assuming T is able to do so, the rest of the analysis in this Example 7 remains the same. Under paragraph (h)(3)(iii) of this section, S derives income from U.S. communications activity because S is paid to transmit the communications between two U.S. points.

Example 8. Indeterminate endpoints--prepaid telephone calling cards--(i) Facts. S purchases capacity from TC to transmit telephone calls. S sells prepaid telephone calling cards that give customers access to TC's telephone lines for a certain number of minutes. Assume that S cannot establish the endpoints of its customers' telephone calls, even under the reasonable method rule of paragraph (h)(3) of this section.

(ii) Analysis. S derives communications income as defined in paragraph (h)(2) of this section because S makes capacity to transmit communications available to its customers. In this case, S cannot establish the two points between which the communications are transmitted. Therefore, S's communications income is U.S. source income, as provided by paragraph (f) of this section.

Example 9. Reasonable methods--minutes of use data on long distance calling plans--(i) Facts. B provides both domestic and international long distance services in a calling plan for a limited number of minutes for a set amount each month. Tracing and identifying the endpoints of each transmission is not possible or practical. B is, however, able to establish that the calling plan generated \$10,000 of revenue for 25,000 minutes based on reports derived from customer billing records. Based on minutes of use data in these reports, B is able to establish that of the total 25,000 minutes, 60 percent or 15,000 minutes were for U.S. long distance calls and 40 percent or 10,000 minutes were for international calls.

(ii) Analysis. B derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, B can establish the two points between which B is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish the endpoints, assuming that this method is consistently applied. In this case, B can reasonably establish that 60 percent of the income derived from the long distance calling plan is U.S. communications income and 40 percent is international communications income based on the minutes of use data derived from customer billing records to establish the endpoints of the communications. If, based on all the facts and circumstances, B could reasonably trace and identify the endpoints, then B would have to directly identify the endpoints between which B is paid to transmit the communications.

Example 10. Reasonable methods--system design--(i) Facts. D operates satellites which are designed to transmit signals through two separate ranges of signal frequencies (bands). Due to technological limitations, requirements, and practicalities, one band is designed to only transmit signals within the United States. The other band is designed to transmit signals between foreign countries and the United States. D cannot trace and identify the endpoints of each individual transmission. D does, however, track the total transmission through each band and the total income derived from transmitting signals through each band.

(ii) Analysis. D derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, D can establish the two points between which D is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish endpoints, assuming that this method is consistently applied. In this case, D can reasonably establish that income derived from transmissions through the first band is U.S. communications income and income derived from transmissions through the second band is international communications income based on the design of the bands to establish the endpoints of the communications.

Example 11. Reasonable methods--port locations--(i) Facts. X provides its customer, C, with a virtual private network (VPN) so that C's U.S. headquarter office can connect and communicate with offices in the United States, Country X, Country Y, and Country Z. Assume that the VPN is only for communications with the U.S. headquarter office. X cannot trace and identify the endpoints of each transmission. C pays X a set amount each month for the entire service, regardless of the magnitude of the usage or the geographic points between which C uses the service.

(ii) Analysis. X derives communications income as defined in paragraph (h)(2) of this section. Based on the facts and circumstances, X can establish the two points between which X is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish endpoints, assuming that this method is consistently applied. In this case, X can reasonably establish that one-fourth

of the income derived from the VPN service is U.S. communications income and three-fourths is international communications income based on the location of the VPN ports to establish the endpoints of the communications.

Example 12. Indeterminate endpoints--Internet access--(i) Facts. B, a domestic corporation, is an Internet service provider. B charges its customer, C, a monthly lump sum for Internet access. C accesses the Internet via a telephone call, initiated by the modem of C's personal computer, to one of B's control centers, which serves as C's portal to the Internet. B transmits data sent by C from B's control center in France to a recipient in England, over the Internet. B does not maintain records as to the beginning and endpoints of the transmission.

(ii) Analysis. B derives communications income as defined in paragraph (h)(2) of this section. The source of B's communications income is determined under paragraph (f) of this section as income from sources within the United States because B cannot establish the two points between which it is paid to transmit the communications.

Example 13. De minimis non-communications activity--(i) Facts. The same facts as in Example 12. Assume in addition that B replicates frequently requested sites on B's own servers, solely to speed up response time. Assume that B's replication of frequently requested sites would be considered a de minimis non-communications activity under this section.

(ii) Analysis. On these facts, because B's replication of frequently requested sites would be considered a de minimis non-communications activity, B is not required to treat the replication activity as a separate non-communications activity transaction under paragraph (h)(1) of this section. B derives communications income under paragraph (h)(2) of this section. The character and source of B's communications income are determined by demonstrating the points between which B is paid to transmit the communications, under paragraph (h)(3)(i) of this section.

Example 14. Income derived from communications and non-communications activity--bundled services--(i) Facts. A, a domestic corporation, offers customers local and long distance phone service, video, and Internet services. Customers pay a flat monthly fee plus 10 cents a minute for all long-distance calls, including international calls.

(ii) Analysis. Under paragraph (h)(1)(ii) of this section, to the extent that A's transaction with its customer consists in part of non-de minimis communications activity and in part of non-de minimis non-communications activity, each such part of the transaction must be treated as a separate transaction. A's gross income from the transaction is allocated to each such communications activity transaction and non-communications activity transaction in accordance with paragraph (h)(1)(ii) of this section. To the extent A can establish that it derives international communications

income as defined in paragraph (h)(3)(ii) of this section, A would determine the source of such income under paragraph (b)(1) of this section. If A cannot establish the points between which it is paid to transmit communications, as required by paragraph (h)(3)(i) of this section, A's communications income is from sources within the United States, as provided by paragraph (f) of this section.

Example 15. Income derived from communications and non-communications activity--(i) Facts. B, a domestic corporation, is paid by D, a cable system operator in Foreign Country, to provide television programs and to transmit the television programs to Foreign Country. Using its own satellite transponder, B transmits the television programs from the United States to downlink facilities owned by D in Foreign Country. D receives the transmission, unscrambles the signals, and distributes the broadcast to D's customers in Foreign Country. Assume that B's provision of television programs is a non-de minimis non-communications activity, and that B's transmission of television programs is a non-de minimis communications activity.

(ii) Analysis. Under paragraph (h)(1)(ii) of this section, B must treat its communications and non-communications activities as separate transactions. B's gross income is allocated to each such separate communications and non-communications activity transaction in accordance with paragraph (h)(1)(ii) of this section. Income derived by B from the transmission of television programs to D's Foreign Country downlink facility is international communications income as defined in paragraph (h)(3)(ii) of this section because B is paid to transmit communications from the United States to a foreign country.

Example 16. Income derived from foreign communications activity--(i) Facts. S provides satellite capacity to B, a broadcaster located in Australia. B beams programming from Australia to the satellite. S's satellite picks the communications up in space and beams the programming over a footprint covering Southeast Asia.

(ii) Analysis. S derives communications income as defined in paragraph (h)(2) of this section. S's income is characterized as foreign communications income under paragraph (h)(3)(iv) of this section because S picks up the communication in space, and beams it to a footprint entirely covering a foreign area. Under paragraph (d) of this section, S's foreign communications income is from sources without the United States. If S were beaming the programming over a satellite footprint that covered area both in the United States and outside the United States, S would be required to allocate the income derived from the different types of communications activity.

(k) Reporting and documentation requirements--(1) In general. A taxpayer making an allocation of gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section must satisfy the requirements in paragraphs (k)(2), (3), and (4) of this

section.

(2) Required documentation. In all cases, a taxpayer must prepare and maintain documentation in existence when its return is filed regarding the allocation of gross income, and allocation and apportionment of expenses, losses, and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must make available such documentation within 30 days upon request.

(3) Access to software. If the taxpayer or any third party used any computer software, within the meaning of section 7612(d), to allocate gross income, or to allocate or apportion expenses, losses, and other deductions, the taxpayer must make available upon request--

(i) Any computer software executable code, within the meaning of section 7612(d), used for such purposes, including an executable copy of the version of the software used in the preparation of the taxpayer's return (including any plug-ins, supplements, etc.) and a copy of all related electronic data files. Thus, if software subsequently is upgraded or supplemented, a separate executable copy of the version used in preparing the taxpayer's return must be retained;

(ii) Any related computer software source code, within the meaning of section 7612(d), acquired or developed by the taxpayer or a related person, or primarily for internal use by the taxpayer or such person rather than for commercial distribution; and

(iii) In the case of any spreadsheet software or similar software, any formulae or links to supporting worksheets.

(4) Use of allocation methodology. In general, when a taxpayer allocates gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section, it does so by making the allocation on a timely filed original return (including extensions). However, a

taxpayer will be permitted to make changes to such allocations made on its original return with respect to any taxable year for which the statute of limitations has not closed as follows:

(i) In the case of a taxpayer that has made a change to such allocations prior to the opening conference for the audit of the taxable year to which the allocation relates or who makes such a change within 90 days of such opening conference, if the IRS issues a written information document request asking the taxpayer to provide the documents and such other information described in paragraphs (k)(2) and (3) of this section with respect to the changed allocations and the taxpayer complies with such request within 30 days of the request, then the IRS will complete its examination, if any, with respect to the allocations for that year as part of the current examination cycle. If the taxpayer does not provide the documents and information described in paragraphs (k)(2) and (3) of this section within 30 days of the request, then the procedures described in paragraph (k)(4)(ii) of this section shall apply.

(ii) If the taxpayer changes such allocations more than 90 days after the opening conference for the audit of the taxable year to which the allocations relate or the taxpayer does not provide the documents and information with respect to the changed allocations as requested in accordance with paragraphs (k)(2) and (3) of this section, then the IRS will, in a separate cycle, determine whether an examination of the taxpayer's allocations is warranted and complete any such examination. The separate cycle will be worked as resources are available and may not have the same estimated completion date as the other issues under examination for the taxable year. The IRS may ask the taxpayer to extend the statute of limitations on assessment and collection for the taxable year to permit examination of the taxpayer's method of allocation,

including an extension limited, where appropriate, to the taxpayer's method of allocation.

(l) Effective date. This section applies to taxable years beginning on or after December 27, 2006.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Par. 5. In §602.101 paragraph (b) is amended by adding an entry to the table in numerical order, §§1.863-8 and 1.863-9, to read as follows:

§602.101 OMB Control numbers.

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(b) * * *

CFR part or section where identified and described	Current OMB control No.
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1.863-8	1545-1718
1.863-9	1545-1718

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Kevin M. Brown
Acting Deputy Commissioner for Services and Enforcement.

Approved: December 21, 2006

Eric Solomon
Assistant Secretary of the Treasury (Tax Policy).